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ZNY CCCCC ZZH
P 211234Z DEC 09 ZDS
FM AMEMBASSY RIGA
TO RUEHC/SECSTATE WASHDC PRIORITY 6192
INFO RUEHZL/EUROPEAN POLITICAL COLLECTIVE PRIORITY

C O N F I D E N T I A L SECTION 01 OF 02 RIGA 000607

C O R R E C T E D C O P Y (TEXT - PARAGRAPH 9)

SIPDIS

E.O. 12958: DECL: 12/20/2019
TAGS: [ECON](#) [EFIN](#) [ENRG](#) [PGOV](#) [LG](#)
SUBJECT: LATVIA: RISKS AND POTENTIAL BENEFITS OF
PRIVATIZATION

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Classified By: P/E Counselor Brian Phipps for reasons 1.4 b & d.

¶1. (C) Some state-owned enterprises (SOEs), including the national electric monopoly, would benefit greatly from the management improvements and infusion of capital that even a partial privatization could bring. However, the GOL is delaying any consideration of the issue until after October elections. Some members of the ruling coalition worry that budget shortfalls could create a political opportunity for a quick privatization benefiting one or more of the country's "oligarchs." Public suspicion about the motives of any privatization runs deep. In most cases, an act of parliament would be required to privatize SOEs, which is unlikely during an election year. The most realistic short-term proposal to move the issue forward is a study group of independent experts that could bolster public trust in a transparent privatization process.

Background

¶2. (U) In recent months, speculation has arisen about a new wave of privatizations. The primary subjects of speculation have been the telecom and power companies (Lattelecom and Latvenergo), though Latvian State Forests, the Riga Airport, the national airline (AirBaltic), the state railroads, and municipal utilities have also been suggested. Though an attempt to sell Lattelecom in 2008 fell through, much of the groundwork for a sale had already been done. At Latvenergo, the country's largest company, speculation has been driven by their own CEO, who told the press that a sale of 20 percent of the company would be a good way to raise capital needed for investments in energy infrastructure.

¶3. (C) The GOL's precarious financial position is driving these rumors. Some observers propose that the government could close a short-term deficit by selling off state-owned assets. Cynics - including Gints Freimanis, economic advisor to the Prime Minister - privately confess that any increase in budget pressure will provide a window of opportunity for "oligarchs" to profit by buying cheap. The governing coalition is shaky and the People's Party or the Union of Greens and Farmers could extract some concessions from the ruling party that is desperate to hold things together and stay on track with commitments to international lenders. IMF representatives said in a private meeting that they would not consider privatizations - one-time conversions of assets into cash - as genuine budget reform in their calculations.

¶4. (U) The leadership of NASDAQ Riga has been pushing the idea of privatization through IPOs on their stock exchange as a means of bolstering its status. Using an IPO would reap the benefits of privatization with much greater transparency, but would entail a longer privatization process. Many SOEs would need significant corporate restructuring and

strengthening of reporting to be salable on the market.

Why Privatize now?

15. (U) The budget crisis also has a secondary effect: The SOEs themselves have to return virtually all profits to the government, leaving no room for reinvesting profit in the businesses. As a result, some SOEs are losing ground against private or foreign rivals. Latvenergo exemplifies this problem. Despite the imminent closure of nearby Ignalina Nuclear Power Plant and electricity prices expected to rise, Latvenergo has been unable to finance renovation of its own power plants.

16. (U) At many Latvian SOEs, boards of directors became patronage positions with little responsibility and hefty salaries. As a result, some boards have been eliminated entirely, leading to complete control by management and no voice for ownership. Meanwhile, SOE managers have seen salaries dwindle in the face of GOL belt-tightening. Privatization would re-introduce responsibility to shareholders and bring management salaries in line with competitors, potentially driving better performance.

Why not?

17. (SBU) Barriers to privatization abound. Foremost, many large SOEs are considered vital to national security and could not be privatized without an act of parliament. With a fractious coalition and elections approaching in October, there is little chance the Saeima (Parliament) will take up the issue - unless it is driven by a party acting on behalf of the potential buyer. Latvenergo's CEO, for example, says that despite his public support for an IPO, he's given up hope of any progress until after the election.

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18. (C) Within the government, the short-term thinking that has plagued their handling of the financial crisis is also working against privatization. Officials at the Ministry of Economics responsible for privatization policy seem to take the legal barriers as a given and don't consider a change in the law realistic. The Privatization Agency (known to be closely tied to Andris Skele and the People's Party) is resistant to the idea of a transparent IPO. Privatization Agency officials argue that the whole point of privatizing is to help get short-term cash, and the IPO process drags on too long. Opening the potential for Russia or Russian-backed actors to buy vital strategic infrastructure also raises concerns. Several of the SOEs have their own unique political entanglements. The privatization of Lativa's "sacred" national forests would meet widespread opposition among most voters, particularly in rural areas.

19. (U) Public trust in the government is weak. According to the latest Eurobarometer poll, only 21 percent of Latvians are satisfied with the way democracy works in their country - one of the lowest ratings in Europe. Many privatizations after the end of Soviet rule were ad hoc and allowed a few individuals to consolidate control of industries at the expense of a naive public - for example, Latvia's gas monopoly is now mostly owned by Gazprom. Newspaper editorials reflect the broad opinion that any privatization is likely to be another scheme to allow oligarchs to buy up national assets in sweetheart deals. Many financial experts also doubt the government has the capacity to properly handle a complex privatization.

Moving forward?

10. (C) NASDAQ has been pushing a study group comprised of financial experts as a first step to begin more strategic,

long-term thinking on the issue of privatization. The Minister of Economics has promised to take the idea to the Prime Minister. Freimanis, the PM's economic advisor, told EconOff that the PM was not interested in pursuing privatization. However, Freimanis recognized that proposing a transparent IPO may be the best counter to pressure for a quick sale to an interested buyer. Serious consideration of the issue by independent experts with no obvious financial stake in the deals would go a lot further toward getting traction on a transparent deal than any pronouncement by politicians.

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